No. 12908

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

J. J. McDONELL,

Appellant,

vs.

PAUL W. SAMPSELL, Trustee of the Estate of Hacker-Byrnes Corporation, Bankrupt,

Appellee.

BRIEF FOR THE APPELLEE.

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BRIEF FOR THE APPELLEE.

Statement of Facts.

In the view taken by the Appellee of the instant appeal, as will appear more fully hereinafter, the problem is primarily one of an interpretation of facts. Appellant has set forth certain bare facts in his "Opening Brief" which Appellee wishes to accent and supplement as follows:

The Appellant, J. J. McDonell, a salesman of some years experience in the carpeting industry [Tr. p. 54], came to work for the bankrupt corporation in the first week of September, 1947 [Tr. p. 52]. The testimony given at the various hearings on this matter indicates, the Referee has so found [Tr. pp. 22-24], and the Appellee does not

dispute, that at that time there was an oral agreement between the Appellant J. J. McDonell and the bankrupt corporation, as represented by Raymond M. Hacker, that McDonell was to receive $150.00 per week salary, plus 50% of the net profits of the carpet department, with a minimum guarantee of $15,000.00 per year [Tr. pp. 53-54, 66-67]. The difference between the $150.00 per week and the minimum to be paid at the end of a year [Tr. p. 67]. Thereafter, during the month of November 1947, Raymond M. Hacker bought out the other stockholder of the bankrupt corporation [Tr. p. 55]. Thereupon a number of meetings, both formal and informal, between Hacker, McDonell and other officers and directors of the bankrupt corporation were held [Tr. pp. 56, 145]. At that time the Appellant J. J. McDonell was made vice-president and general manager and a director of the bankrupt corporation [Tr. pp. 62-63]. Results of these meetings were a number of agreements between the corporation and various directors, officers and employees, materially increasing the salaries of these employees, and guaranteeing to them a substantial share of the profits [Tr. pp. 56, 59]. As far as the Appellant McDonell is concerned, the testimony shows, the Referee so found [Tr. pp. 22-24] and the Appellee herein does not dispute, that there was a contract whereby the Appellant McDonell was to receive, beginning January 1, 1948, a guaranteed salary of $20,000.00 per year, payable $150.00 per week beginning January 1, 1948, and the difference between the $150.00 per week and $20,000.00 to be paid at the end of the year

[Tr. pp. 55, 59, 67]. In addition the Appellant J. J. McDonell was to receive at the end of the year 15% of whatever profits were left over after the payment of any and all expenses of the bankrupt corporation, including the various guaranteed salaries then under discussion [Tr. pp. 55, 59, 90].

The Appellant, J. J. McDonell, continued in the employ of the Hacker-Byrnes Corporation until February 18, 1949, [Tr. p. 60]; and received at all times $150.00 per week [Tr. pp. 67-70]. He never was paid any part of the balance between this $150.00 per week and the "guaranteed salary" [Tr. pp. 60-61]; nor was the Appellant ever paid any sums under the foregoing percentage of profit arrangement. It is the discrepancy between his salary and the guaranteed amount which forms the basis of the claim of the Appellant in the amount of $16,664.00 [Tr. pp. 17, 61].

The claims as filed in the bankruptcy by J. J. McDonell are two: a general unsecured claim for $16,064.00 [Tr. p. 17] and a claim for $600.00 which was asserted to be entitled to priority [Tr. p. 16]. The Findings and Conclusions and Order of the Referee disallowed any prior aspects of the claim of J. J. McDonell [Tr. pp. 32, 33] and it is Appellee's understanding that this claim of priority has been abandoned by the appellant McDonell. Consequently, as Appellee now understands the facts, Appellant J. J. McDonell is asserting a general unsecured claim for $16,664.00. (An inspection of Appellant's Opening Brief on file in this matter indicates that this is the situation.)

Statement of Law.

I.

The Bankruptcy Courts are generally recognized as courts of equity, *Local Loan Company v. Hunt* 292 U. S. 234; *Reconstruction Finance Corporation v. Prudence Securities Advisory Group* (1941), 311 U. S. 579 (See concurring opinion); *Pepper v. Litton* (1939), 308 U. S. 295. And, sitting as such courts, it now seems generally conceded that the Bankruptcy Courts may subordinate payment of certain claims in the interest of justice and equity to other claims of the same rank, (See *Collier* on Bankruptcy, 14th Ed., Sec. 57.14.) As the rule is so admirably stated in *Pepper v. Litton*, cited *supra*, by Justice Douglas:

> "In the exercise of its equitable jurisdiction the bankruptcy court has the power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in the administration of the bankrupt estate. And its duty so to do is especially clear when the claim seeking allowance accrues to the benefit of an officer, director or stockholder."

II.

In California the fiduciary position of officers and directors is declared by statute. By California Corporation Code Section 820:

> "Directors and officers shall exercise their power in good faith and with a view to the interest of the corporation."

See also Ballantyne on Corporations 1949 Ed. Sec. 84; *Western States Life Insurance Company v. Lockwood*, 173 Cal. 734; *Schnittger v. Oil Home Etc. Mining Company*, 144 Cal. 603. In bankruptcy the existence of this duty requires that claims of officers and directors be scrutinized with the greatest of care when asserted against the bankrupt corporation.

> "A director is a fiduciary. *Twin Lock Oil Company v. Marbury* 91 U. S. 587, 588 * * * their powers are powers in trust. See *Jackson v. Ludling*, 21 *Wall* 616, 624. Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the director—not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein. *Giddes v. Anaconda Copper Mining Co.* 254 U. S. 590, 599. *The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain. If it does not, equity will set it aside.* While normally that fiduciary obligation is enforceable directly by the corporation * * * it is, in the event of bankruptcy of the corporation, enforceable by the trustee. (Citing Bankruptcy Act Sec. 70a (6) and *Dean v. Shingle* 198 Cal. 652.) For that standard of fiduciary obligation is designed for the protection of the entire community of interests in the corporation—creditors as well as stockholders." Cited from *Pepper v. Litton* 308 U. S. 295, 298. (Emphasis supplied.)

III.

Appellee has inspected all the authorities cited by Appellant in his "Opening Brief" and cannot see that any of those authorities enunciate rules different from those immediately heretofore set down. Those authorities, taken with the others cited here, merely serve to emphasize that each case of subordination must be determined on its particular facts—that all circumstances must be considered when attempting to adjust the equities. The instant review is no different: Upon all the facts the Referee has held, and has been sustained upon review by the District Court, that it would be unjust and unfair to permit Appellant J. J. McDonell to participate equally with other general unsecured creditors in this case. The final determination, then, must rest upon a conclusion drawn from the facts as to whether or not the evidence before the Court was sufficient to justify the exercise of the undoubted equitable powers of subordination of the Bankruptcy Court.

QUESTION PRESENTED.

Granting That Appellant Has a Valid Unsecured Claim Against the Bankruptcy Estate in the Amount of $16,664.00, Should That Claim Be Allowed to Participate on a Parity With the Allowed Claims of Other General Unsecured Creditors in This Case?

ARGUMENT.

I.

It Is Not Fair, Equitable or Just to Permit the Claim of Appellant to Share on a Parity With Other General Unsecured Creditors Because of the Fiduciary Relationship Appellant Occupied in the Bankrupt Corporation.

As has been indicated hereinbefore, in the view taken by Appellee the resolution of this appeal depends entirely upon the interpretation placed upon the testimony given before the Referee. The conclusion of law reached by the referee [Tr. pp. 30-32] sets forth in great detail the precise approach taken by the Referee, in which he was sustained by the District Court, in determining an answer to the question here presented. That finding is set forth here as a guide in determining this matter upon appeal because in appellee's view of this case this conclusion, and the reasons given by the Referee in support thereof, present the pivotal issue in this case:

> "That each and all of the aforesaid enforceable contracts were not fair, equitable or just and are not fair, equitable or just, as against the creditors of the bankrupt corporation, for these reasons, among others, to-wit: (1) that from and after November 1947, the claimants, McDonell and Egan, were officers and directors of the bankrupt corporation and, as such, were charged with the responsibility of providing for the payment of all of the just obligations of the bankrupt corporation, which was not done for it appears that at the date of the termination of its business the cor-

poration was heavily indebted to its creditors and its liabilities were substantially in excess of its assets; (2) that the "guaranteed salaries" aforesaid were excessive and unreasonable in the light of the ability of the bankrupt corporation to pay the same and, at the same time, to discharge the obligations which it incurred while the said salaries were being earned; (3) that the rights given to the said claimants to participate in the profits, if any, of the bankrupt corporation and the postponement of the time of payment of a substantial portion of their respective "guaranteed salaries" to the rather indefinite time of the expiration of one year, gave the said claimants an unfair and inequitable advantage over the creditors of the bankrupt corporation in that, if the corporation prospered during the period of the aforesaid postponement, the claimants would collect their said salaries in full and, at the same time, would be entitled to their respective shares of the profits earned in such period; whereas, if, in such period, the corporation did not prosper and no profits were earned, the claimants would still be entitled to claim the unpaid portions of their respective salaries on a parity with all other creditors of the corporation, including the creditors to whom the corporation became indebted during the period of such postponement; and, furthermore, the said postponement of the time of payment of a portion of said "guaranteed salaries" resulted in the accumulation of liabilities by the corporation for the payment of such salaries during a period when it was unable to actually pay the same and thus the said postponement was a factor in keeping the corporation in business and in the incurring by it of further liabilities to creditors which it was eventually unable to pay; whereas, if the said "guaranteed salaries" had all been payable in normal

installments, the corporation, if it had been unable to pay the same when due, might have been compelled to discontinue its operations and might thus have avoided incurring the said further liabilities which eventually it was unable to pay; (4) that when one considers the substantial amounts of the aforesaid "guaranteed salaries" and the substantial percentages of the profits of the bankrupt corporation to which the said claimants were entitled, one is impressed with the idea that the relationship of each of the said claimants was more of the character of the relationship of a partner or a joint adventurer, rather than that of a profit sharing employee and, hence, that the said claimants, in equity, are not entitled to any greater rights, as against the creditors of the corporation, than partners or joint adventurers would have, even though the said claimants may have none of the liabilities to such creditors such as partners or joint adventurers might have."

It is proposed to examine each of the reasons the Referee advanced for subordination, and in which he was supported by the District Court, in the light of the evidence given in this case.

The evidence is uncontradicted that the Appellant J. J. McDonell, was at the time of the making of the contract to pay him $20,000.00 a year "guaranteed salary," an officer and director of the bankrupt corporation [Tr. p. 63]. Nor can it be gainsaid that the bankrupt became in the year 1948 heavily involved financially, so heavily involved that an assignment for benefit of creditors was made March 21, 1949 followed by bankruptcy in April 1949 [Tr. pp. 5, 10]. At Bankruptcy there were large numbers of unsecured trade creditors with large claims whose indebtedness was contracted for during the year

1948 while the Appellant McDonell was an officer and director [Tr. p. 63]. The Referee, as indicated above, felt that it was not fair, equitable or just that the Appellant McDonell as an officer and director should sit by and perceive that the corporation was in financial difficulties, knowing that with the passage of every week a larger indebtedness accrued to him which did not appear upon the books and for which no reserve was being created [Tr. p. 76] and then at the end come forward with that claim and attempt to assert it on a parity with the other creditors in this matter.

It must always be kept in mind that during most of the period while the corporation sank deeper and deeper into financial difficulties, and while his deferred salary grew ever larger, the Appellant McDonell was an officer and director of the bankrupt corporation [Tr. p. 63]. Nor can he be permitted to contend, as extenuation, that he was the creature of Raymond Hacker the principle stock-holder; no one forced him to accept a position as an officer and director; he consented to be such freely, probably feeling it to be the proper station for one who was daily contributing a sizable sum to the operating capital by deferring the major portion of his income to some time in the future when the bankrupt might better be able to pay. Furthermore, the testimony of Hacker indicates [Tr. pp. 99-105] that McDonell and the other officers and directors were consulted as to the larger decisions affecting the Hacker-Byrnes Corporation: they were evidently not mere "yes-men" serving in a purely nominal way.

II.

It Is Not Fair, Equitable or Just to Permit the General Unsecured Claim of Appellant to Share on a Parity With Other General Unsecured Creditors Because the Uncollected "Guaranteed Salary" Which Is the Basis of Appellant's Claim Itself Contributed to the Large Amount of Debts Confronting This Bankrupt Estate.

The testimony of the Appellant McDonell indicates that he knew when he came to the Hacker-Byrnes Corporation in September 1947, that the carpet department which he had been hired to manage and develop was not capable of paying him the "guaranteed salary" of $15,000.00 per year [Tr. pp. 53, 54, 68]. The testimony of McDonell on this point is most instructive. In response to questions concerning his original contract McDonell testified as follows [Tr. pp. 53, 54]:

> A. (By McDonell) "He gave me a guarantee of $15,000.00. When I went there Mr. Hacker didn't have very much of a rug department. He asked me for a year or two prior to that to come and work for him; and at the time that I went to work for him he didn't have any of the major carpet lines, and I felt, and I told him so at the time, that it wasn't going to be a deal where we could build up a business overnight, it was going to take a little time to build it; and he told me at that time he didn't expect to make any money for maybe a year or two, that he was willing to give me a guarantee of $15,000.00 a year and a share of the profits of 50 per cent. Whatever the $15,000.00 was, that was a guaranteed amount, whether we made any money in the rug department or not, and I didn't expect to make any the first year."

Likewise, according to the testimony of McDonell [Tr. p. 62] he knew shortly after becoming an officer and director, and about the time that the larger contract for the payment of a "guaranteed salary" of $20,000.00 was under discussion, that finances were so tight and capital so short that it was difficult for the corporation to obtain merchandise.

> "A. (By Mr. McDonell) The first month or the first few months—as I say, Mr. Hacker didn't have any of the major lines of carpet or anything. We didn't have anything much to sell. By the end of that year—I started in September. By the end of that year we had secured one contract on which there was about $9,000.00 profit made. That was the second year I was there. *After Mr. Byrnes got out and after the first of the year finances were such, getting tighter all the time, that it made it almost impossible to get merchandise.*" (Emphasis supplied.)

The testimony of Edmund G. Egan taken at the same hearing [Tr. p. 91] indicates that all the officers and directors knew at the time of the making of the employment contracts, of which the appellant McDonell's was only one, that the corporation would be unable to immediately pay the large salaries promised.

> "Q. (My McDonnell) Why wasn't the entire amount to be apportioned on the 52-week basis and paid at that time?
>
> A. (By Ednund G. Egan) Because we didn't want to bleed the corporation of all the cash, you see, in it. We were trying to build up a new business."

The testimony of a number of witnesses at the hearing was to the effect that in May 1948 the Hacker-Byrnes Corp. was in sufficient straitened financial circum-

stances as to necessitate a sizable "across the board" reduction in the salaries of all principal employees including McDonell [Tr. p. 84]:

> "Q. (By Mr. Gilbert): Now, Mr. Egan, there has been some uncertainty about the matter of the reduction of the salaries for $150.00 a week in your case to $100.00 a week, in May. Would you explain to the Court how that came about?
>
> A. (By Mr. Egan): Well, I possibly was the one that recommended it, *that everybody should take a cut to help the corporation out over a period of time when we needed the money to possibly pay other bills with.*" (Emphasis supplied.)
>
> "Q. Was it your intention in recommending that you were to receive any less on your basic salary, let us say—some people here have referred to it as a guaranteed salary—when you took that particular cut?
>
> A. *No, that was just some immediate help to raise enough capital or lower our overhead enough so we could meet some bills that were pending at the time.* We were doing such a large amount of work we needed a lot of capital at certain times to be able to meet our material bills." (Emphasis supplied.)

It is true that McDonell did not suffer by reason of the aforesaid cut in salary because the difference was made up to him secretly out of Raymond M. Hacker's private funds [Tr. pp. 67-68].

In the face of such evidence, the appellee contends that the claimant McDonell would have had to be a blind optimist to suppose for even a moment that this corporation, struggling as it was to free itself from a mire of debt,

could hope to pay him at the end of a year, or any other time, the balance between $150.00 per week and a $20,000.00 a year guarantee. McDonell, as general manager, must have known the unreasonableness of his salary in view of all the circumstances.

The claim of Appellant cannot be considered in a vacuum: the contract with J. J. McDonell must be considered as part and parcel of a general optimistic plan to pay all the top executives of the Hacker-Byrnes Corporation large salaries, plus a sizeable percentage of the profits which one and all hoped would be made. In addition to McDonell, at the same time, Edmund J. Egan was promised a "guaranteed salary" of $12,000.00 payable $150.00 per week and the balance payable at the end of a year [Tr. pp. 80-84, 89-91]. Glen G. Savage, at or about the same time, was also promised a minimum salary of $12,000.00 per year, payable $150.00 per week and the balance at the end of the year [Tr. pp. 59, 90, 100]. Robert W. Schuler was likewise to receive a minimum salary of $12,000.00 per year, payable $150.00 per week and the balance at the end of a year [Tr. pp. 59, 90, 100]. Finally, Raymond M. Hacker was to draw a salary of $25,000.00 per year, though the record is silent as to exactly how it was to be paid [Tr. pp. 59, 109]. Thus we see that "guaranteed salaries" to a total of $81,000.00 per year were proposed for the top executives of a company which was at the time having difficulty meeting its current obligations. Merely to state the sanguine hopes in this case is to indicate that they were no more than just that: hopes impossible of immediate fulfilment by a corporation which may have had rosy promise, but certainly had little or no liquid capital with which to operate.

III.

It Is Not Fair, Equitable or Just to Permit the General Unsecured Claim of Appellant to Share on a Parity With Other General Unsecured Creditors Because Appellant's Claim Arises Out of Dealings Wherein Appellant Had Advantages Because of His Fiduciary Position Over Outside Creditors Who Dealt With the Bankrupt at Arms' Length.

In considering whether or not the claim of J. J. McDonell should be subordinated, the appellee submits that the following is a true and correct analysis of the result of the opulent employment contract between McDonell and the corporation: McDonell was given a stipend of $150.00 per week. He left with the corporation the difference each week between $150.00 and $384.62, the weekly amount of his guaranteed salary, allowing this difference to accumulate to some distant date, when he hoped the corporation would be in a position to pay him the large sum of cash due him, which he knew could not be done as the corporation went along. In the meantime, of course, the accumulating fund was left with the corporation which was desperately short of liquid capital and enabled the corporation thus to have this additional margin for operation. At the same time, debts to outside creditors were being incurred and left unpaid. The Appellant McDonell was thus in a position of assisting the business to remain afloat, and incur more obligations which it was not paying, with the assurance that if and when the corporation was a success his money could be collected, together with a sizeable share of any net

profits. On the other hand, if the corporation was a failure, the appellant McDonell could then come forward, as he has done, with a large claim against the assets of the corporation which would stand on a parity with the other debts for which the conduct of the appellant McDonell and this employment contract were at least in part responsible. Considered in this light, can it be said that it would be fair for the appellant McDonell, who was for a considerable time an officer and director of the bankrupt corporation, to share equally with other creditors, the existence of whose debt could be traced in part to McDonell's contract? A contract, be it noted, which was entered into while McDonell occupied a fiduciary capacity *vis-a-vis* the corporation and its creditors. Appellee contends that such a consideration is abhorrent to the conscience of the court, that such Appellant has not "done equity" and that therefore under the equitable power of the Bankruptcy Court such a claim should be subordinated.

IV.

It Is Not Fair, Equitable or Just to Permit an Unsecured Claim of Appellant to Share on a Parity With Other General Unsecured Creditors Because Appellant Occupied a Position More Intimate With the Bankrupt Corporation Than That of a Mere Employee.

Before considering the last argument of appellee, a certain misapprehension under which the appellant McDonell seems to be laboring should be corrected. A sizeable portion of the "Opening Brief" of the Appellant on file herein is directed to a demonstration that under the California law appellant cannot possibly be a "joint venturer" and that therefore there is error in the Referee's Findings on this head [Tr. p. 32]. It is submitted that this argument entirely misconceives and misunderstands the Referee's Findings in this matter. The Findings of the Referee, which were sustained by this District Court, were in part as follows [Tr. p. 32]:

> "* * * one is impressed with the idea that the relationship of each of the said claimants was *more of the character* of the relationship of a partner or a joint adventurer, rather than that of a profit sharing employee and, hence, that the said claimants, in equity, are not entitled to any greater rights, as against the creditors of the corporation, than partners or joint adventurers would have, *even though the said claimants may have none of the liabilities to such creditors such as partners or joint adventurers might have.*" (Emphasis supplied.)

As will be seen from this quotation, the Referee did not at any time declare that McDonell was a joint venturer

with the bankrupt corporation. There was not involved a question of liability and it is clear that the Referee had no intention of finding, nor did he find, that the appellant qualified technically as a joint venturer. What is involved here is a question of equity and the Referee in his Findings merely indicated that the conduct of the appellant, and other claimants who were substantially in the same position, was such as to be "more of the character of the relationship of a partner or joint venturer rather than that of a profit sharing employee." It is upon this basis that the matter should be considered and not in the distorted light which Appellant has cast upon it.

In connection with this Finding a very significant portion of the testimony of Edmund Egan should be kept in mind when attempting to evaluate the nature of the contract in this case. Consider the testimony given by Egan [Tr. p. 85]:

> "Q. (By Mr. Gilbert): Mr. Egan, have you at any time had any financial or pecuniary interest in the corporation other than that as an employee? A. (By Mr. Egan): No, I never did own stock. At the time—*there is something that hasn't come up*—at the time this agreement was made as far as profit-sharing was concerned, Mr. Hacker stipulated that until—let me put it this way: that *when and if the profits were to be split up by those percentages as we have set forth, as they were set forth, they were to be utilized or to be used in making us able to buy stock with the particular percentage of profit rather than taking it out in cash and bleeding the company.*" (Emphasis supplied.)

This testimony is uncontradicted—even on subsequent testimony by Appellant. Appellee submits that this testi-

mony reveals the true nature of the employment contracts between the bankrupt corporation, McDonell and the other executives of that corporation. Apparently there was some understanding on the part of the employees that these contracts would result in an ownership interest in the bankrupt corporation. That this hope never reached fruition is a circumstance dependent upon subsequent events (the failure of the bankrupt corporation) and not upon the nature of the contract itself.

Is this the usual profit sharing contract? The Appellee herein contends it is not, but, as the Referee has found, it is in equity a part of a large design whereby a number of men pooled their efforts and capital in the hope of future aggrandizement. Such persons, of which Appellant McDonell is one, should not be permitted to come forward upon the darkening of their hopes and demand to stand on a level with other creditors, who, dealing at arm's length, sold merchandise and loaned money to the bankrupt corporation.

Conclusion.

In summary, Appellee contends that in the interest of justice and equity the claim of Appellant J. J. McDonell should be subordinated to the payment of other general creditors in this bankruptcy estate because (1) The claim is asserted by one who was an officer and director charged with the fiduciary duty to see that insofar as possible the just obligations of the bankrupt were paid. Appellant occupied such a fiduciary position at the date the contract was made, for a number of months thereafter during which the large obligations now confronting this bankruptcy were accumulated, and at all times was the active general manager of the bankrupt corporation. (2)

And further because the "guaranteed salary" claimed by Appellant was excessive and unreasonable in the light of the bankrupt corporation's financial position, both when the contract was made and throughout the days ensuing to the date of bankruptcy herein. (3) And further because the "guaranteed salary" of the Appellant gives to him an unfair and unequitable advantage over those who dealt with the bankrupt corporation at arm's length. (4) Finally, an inspection of all circumstances surrounding the making and performance of this contract indicates that as a result of the said employment contract with the "guaranteed salary" attached that Appellant appears more in the role of a joint adventurer than that of a mere employee. As such he should be treated, in equity, as one closer to the bankrupt than were creditors dealing with it at arm's length.

For the reasons set out hereinabove the claim of Appellant should be subordinated to the payment of other general unsecured creditors in this bankruptcy matter and the order of the District Court sustaining the Order made by the Referee to this effect is correct and should be sustained.

Respectfully submitted,

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